In the Supreme Court of the United States

OCTOBER TERM, 1924

CHARLES V. DUFFY, FORMER COLLECTOR OF Internal Revenue, petitioner
v.
THE MUTUAL BENEFIT LIFE INSURANCE Company
No. —

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General, on behalf of Charles V. Duffy, former Collector of Internal Revenue for the Fifth District of New Jersey, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above case on March 2, 1925, affirming the judgment of the District Court of the United States for the District of New Jersey.

STATEMENT OF THE CASE

This is an important test case involving practically every life insurance company in the United States.

Respondent is a New Jersey corporation, chartered in 1845 for the transaction of the business of life insurance on the mutual plan. It has no capital stock represented by shares and no stockholders as such, the policyholders of the company constituting the members thereof. The business is conducted on the "level premium plan," under which the natural premiums, which increase in proportion to the age of the insured, are leveled and a maximum premium is paid annually throughout the life of the policy. During the early years of the policy this premium is in excess of the current cost of insurance, and during the later years it is less than cost. The excess paid in the early years is carried as a "reserve" to mature the policy by maintaining the insurance in the later years when the level premium would be insufficient to meet the current cost of insurance on the natural premium plan.

This reserve is required by the laws of the various States in which the company does business. Its amount is computed annually by the Commissioner of Banking and Insurance of the State of New Jersey, whose computation is accepted by the other States, with the exception of Massachusetts, where an independent computation is made. On January 1, 1917, the reserve required by New Jersey was $186,258,796, and by Massachusetts, $185,638,632.

Under the provisions of Title I of the Revenue Act of September 8, 1916, as amended by Title I

of the Revenue Act of October 3, 1917, 40 Stat. 300, Chap. 63, respondent filed an income-tax return for the year 1917, and paid a tax of $108,500.36. It also filed, pursuant to the provisions of Title II of the Act of October 3, 1917, *supra*, an excess-profits return for the same year, showing no tax due or payable. In this return respondent included as part of its "invested capital" under Section 207 of said Act, and claimed a deduction under Section 203 of the Act, the amount of the legal policy reserve of $186,258,796, required by the State of New Jersey for the year 1917.

Upon audit of the excess-profits tax return the Commissioner of Internal Revenue deducted this sum from the "invested capital" of respondent on the ground that the reserve was a "liability" and should be excluded in computing "invested capital." This resulted in an assessment of $83,779.70 as an excess-profits tax, which was paid under protest, and this suit was instituted for its recovery. The District Court gave judgment for the plaintiff, and on writ of error the Circuit Court of Appeals for the Third Circuit affirmed the judgment.

QUESTION PRESENTED

Is the legal policy reserve of a mutual life-insurance company to be deducted as a liability in computing "invested capital" of the company within the statutory definition of that term contained in Section 207 of Title II of the Revenue Act of October 3, 1917?

THE STATUTES

The pertinent parts of Title II of the Revenue Act of October 3, 1917, 40 Stat., Chap. 63, pp. 300, 302–306, providing for the payment of a War Excess Profits Tax, are as follows:

> SECTION 200. That when used in this title—
>
> The term "corporation" includes joint-stock companies or associations and insurance companies;
>
> * * * * *
>
> SECTION 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income: [The percentages follow.]
>
> * * * * *
>
> SECTION 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—
>
> (a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the pre-war period was of the invested capital for the pre-war period (but not less than seven or more than nine per centum of the invested capital for the taxable year) and (2) $3,000. * * *

SECTION 207. That as used in this title the term "invested capital" for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:

(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year. * * *

REASONS FOR GRANTING THE PETITION

1. The Circuit Court of Appeals erred in holding with the District Court that the legal reserve of a mutual life insurance company which is a "liability" on policy contracts constitutes a part

of its "invested capital" within the statutory definition of that term, as provided by Section 207 of the Revenue Act of 1917, *supra.*

2. The court erred in not following the principles heretofore laid down by this court in *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, and *La Belle Iron Works* v. *United States,* 256 U. S. 377.

3. This is a test case. It is the first time the question involved has arisen for judicial decision.

4. The case is one of great public interest and of great importance to the Government in the administration of the revenue laws. It affects every mutual life insurance company in the United States. If the decision remains unreversed, no excess-profits tax will be payable by any life insurance company, because the deduction permitted under the court's construction will be so large as to entirely eliminate such tax.

5. The amount involved in this and many similar cases now pending in the courts and before the Treasury Department is approximately $25,000,000. A determination of the question by this Court will establish a rule for the settlement of these cases.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Third Circuit should be granted.

JAMES M. BECK,
Solcitor General.

ARGUMENT

I

For the "legal reserve" to be deducted it must fall within the statutory definition of "invested capital"

"Invested capital" as defined by Section 207 of the Revenue Act of 1917 differs in many respects from the ordinary meaning of the word "capital." (*Porter* v. *Lederer,* 267 Fed. 739, 740.) It is a statutory definition carefully restricted by both inclusive and noninclusive clauses. This was recognized by this Court in *La Belle Iron Works* v. *United States,* 256 U. S. 377, 387–388, where it is said that—

> Section 207 shows that Congress * * * designedly adopted a term—"invested capital"—and a definition of it. * * * The word "invested" in itself imports a restrictive qualification. * * *

Therefore in order for the legal reserve of a mutual life insurance company to be included in "invested capital" it must fall within the statutory definition of that term as found in subdivisions (1), (2), or (3) of Section 207 (a) of said Act.

Subdivisions (1) and (2), which relate to cash or other property paid in for stocks or shares, are clearly not applicable. As this Court said in *La Belle Iron Works* v. *United States, supra,* p. 388:

> Cash paid in, and tangible property paid in other than cash, are confined to such as

> were contributed for stock or shares in the corporation or partnership. * * *

And again, p. 389:

> It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it. * * *

This interpretation is in accord with Section 326(a) of the Revenue Act of 1918, which adopts the definition of "invested capital" of the 1917 Act except that subdivision (1) thereof reads "Actual cash bona fide paid in for stock or shares."

Respondent is a mutual life insurance company and has no capital stock represented by shares. Consequently its legal reserve is not "invested capital" within the meaning of subdivisions (1) and (2) of Section 207(a) of said Act.

The question, then, narrows down to whether the legal reserve falls within subdivision (3) of Section 207(a) and constitutes "paid in or earned surplus and undivided profits used or employed in the business."

II

The legal reserve of a mutual life-insurance company is not "paid in or earned surplus or undivided profits used or employed in the business"

Certainly the legal reserve of a mutual life insurance company is not "undivided profits." It is

not "profit" in any sense of the word. It is a sum certain set aside to meet an absolute "liability." It is essentially a trust fund belonging to the policyholders established to assure payment of the policy in full at death. (*Fink* v. *Northwestern Mutual Life Insurance Company,* 267 Fed. 968; *Blanchard* v. *Prudential Insurance Company,* 80 N. J. Eq. 209; *Connecticut Mutual Life Insurance Company* v. *Commonwealth,* 133 Mass. 161; *United States Life Insurance Company* v. *Spinks,* 29 Ky. Law Rep. 960; rehearing, 31 Ky. Law Rep. 185.)

It thus remains to determine whether the legal reserve constitutes "paid in or earned surplus." Congress has not attempted to define these words, but they necessarily exclude surplus which is not "paid in or earned." It is not all surplus used or employed in the business which is included in "invested capital," but expressly only such as is "paid in or earned." These words are significant. They necessarily exclude "liabilities."

There is a clear distinction between the "legal reserve," the "contingent reserve," and the "surplus" of a mutual life insurance company. The "legal reserve" is a fund set aside from premiums to meet the liability for payment of the policy when it matures. The "contingent reserve" is a part of surplus set aside to meet extraordinary conditions. "Surplus" is the profit earned over and above the liability represented by the "legal reserve." In its ordinary sense and

in accounting, "surplus" includes the entire overplus of "assets" over "liabilities." It is what remains after making provision for all "liabilities" of every kind. *Bank of Commerce* v. *Tennessee,* 161 U. S. 134; *Insurance Company of North America* v. *McCoach,* 224 Fed. 657; reversed on another point, 244 U. S. 585.

Being thus a "liability" the legal reserve should be deducted from the "assets" of a mutual life insurance company in determining the true surplus constituting "invested capital" within the meaning of the statute.

III

The legal reserve is a deferred liability and not an "asset" and does not constitute "invested capital" of the company

That the legal reserve of a mutual life insurance company is a fixed and definite "liability" is abundantly clear. It is not a contingent liability, but a present existing liability as absolute and certain as is the death of the insured. (*Carr* v. *Hamilton,* 129 U. S. 252, 256.)

The legal reserve is carried as a "liability" in the annual reports of every life insurance company to the various State insurance commissioners.

It has been held for the purposes of State taxation to be deductible as a "liability." Pursuant to a New Jersey statute providing for the taxation of mutual life insurance companies after de-

ducting "debts and liabilities," the Prudential Insurance Company presented a statement including among its liabilities "reserves on policies (New Jersey Commissioners of Insurance Valuation) $132,138,211." This was recognized by the highest courts of New Jersey as a proper deduction for State tax purposes. (*Mayor, etc., of Newark* v. *Board of Equalization,* 80 N. J. L. 258; affirmed 81 N. J. L. 416.)

If the legal reserve is to be deducted as a "liability" and not included in "surplus" for purposes of State taxation, how can it at the same time be "surplus" and "invested capital" for purposes of Federal taxation?

The rule of the New Jersey courts that the legal reserve is a "debt or liability" is also the rule in New York, where it is held to be a "liability" and not "surplus." (*Greeff* v. *Equitable Life Assurance Company,* 160 N. Y. 19; *Farmers' Loan & Trust Company* v. *Aberle et al.,* 19 App. Div. N. Y. 79; *In re Equitable Reserve Fund Life Association,* 131 N. Y. 354; *People* v. *Life Union,* 31 N. Y. S. 1120.)

The rule of the New Jersey and New York courts also prevails in other States where it is held that the reserve fund is a "liability" of the company. (*Equitable Life Insurance Company* v. *Board of Equalization,* 74 Iowa 178; *Hawkeye Insurance Company* v. *Board,* 75 Iowa 770; *Alabama Gold Life Insurance Company* v. *Lott,* 54 Ala. 499; *Michigan Mutual Life Insurance Company* v.

Common Council, 133 Mich. 408; *Commonwealth* v. *Berkshire Life Insurance Company,* 98 Mass. 25.)

It is, then, thoroughly established that the reserve fund of a mutual life insurance company is not an "asset" but an actual deferred "liability." Therefore, it can not constitute "paid in or earned surplus" or "undivided profits" within the definition of "invested capital" contained in Section 207 of the Revenue Act of 1917.

This interpretation finds support in the case of *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, 534. In that case this court said that "the service performed in level-premium life insurance is both protection and investment." On page 531 an analogy was drawn between a savings deposit in a bank and the premium paid in insurance, Mr. Justice Brandeis saying:

> But in level-premium life insurance, while the motive for taking it may be mainly protection, the business is largely that of savings investment. The premium is in the nature of a savings deposit. Except where there are stockholders, the savings bank pays back to the depositor his deposit with the interest earned less the necessary expense of management. The insurance company does the same, the difference being merely that the savings bank undertakes to repay to each individual depositor the whole of his deposit with interest; while the life insurance company undertakes to pay to each member of a class

> the average amount (regarding the chances of life and death). * * *

The method adopted by the Commissioner of Internal Revenue in computing the "invested capital" of respondent company was the same as that used in computing the "invested capital" of a bank. In the case of a bank "deposits" are included among cash "assets," but for the purpose of determining the "invested capital" the amount of deposits is deducted as a "liability," and the net over and above liabilities constitutes "invested capital." Insurance premiums paid are part of the cash "assets" of the company, but the reserve is a part of those premiums set aside as "liability." Therefore, in computing the "invested capital" of a mutual life insurance company, the amount of the reserve should be deducted as a liability from the assets, and the "invested capital" is the net assets over and above the reserve liability.

IV

It was not the intent of Congress that the legal reserve should be included as "invested capital"

By section 200 of the Revenue Act of 1917, Congress made the excess-profits tax provisions of the Act applicable to all insurance companies.

When the first excess profits tax act of March 3, 1917, was under consideration representatives of the various life insurance companies appeared at the hearings of the Senate Subcommittee on

Finance and urged that the proposed excess profits tax would not allow the companies to consider as "invested capital" their reserve funds. It was also submitted that the companies had no actual "cash paid in" and that the only surplus was the contingent reserve over and above all liabilities, the "legal reserve" being considered as a liability and not an asset. (*Hearings Before the Senate Subcommittee on Finance, 64th Congress, 2nd session,* H. R. 20573, pp. 45, 48, 52, 60.)

When the Revenue Act of October 3, 1917, was under consideration an amendment was offered on behalf of life insurance companies to expressly include the legal reserve of a mutual life insurance company as "invested capital." (*Hearings before the Senate Subcommittee on Finance, 65th Congress, 1st Session,* H. R. 4280, p. 258.) This amendment was not adopted by Congress.

When the Revenue Act of 1918 was under consideration a similar amendment was again urged upon Congress. (*Hearings before the Committee on Ways and Means on the Proposed Revenue Act of 1918,* Part 1, pp. 800, 811.) This amendment was also not adopted by Congress.

This history is similar to that considered in *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, involving exemption of life insurance companies from the provisions of the Income Tax Act of 1913, where this court said (p. 534):

> Congress exempted certain cooperative enterprises from all income taxation, * * *

> but * * * it imposed in express terms such taxation upon "every insurance company."
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> Footnote 1. The alleged unwisdom and injustice of taxing mutual life insurance companies while mutual savings banks were exempted had been strongly pressed upon Congress. Briefs and statements filed with Senate Committee on Finance on H. R. 3321—Sixty-third Congress, First Session, Vol. 3, pp. 1955–2094.

So in this case the insurance companies repeatedly endeavored, without success, to prevail upon Congress to incorporate express language in three successive acts which would include the legal reserve in "invested capital." The consistent refusal of Congress to do so distinctly expresses its intent.

This intent is further shown by the exclusion of the legal reserve of life-insurance companies from capital-stock tax on surplus and undivided profits imposed by Section 407 of the Revenue Act of 1916. It is inconceivable that Congress intended the legal reserve to occupy a dual status—to be excluded from surplus and undivided profits for the purpose of capital-stock tax and yet be included as surplus and undivided profits, that is, "invested capital," for the purpose of the excess-profits tax.

Moreover, the net addition to legal reserve is not subject to income tax under Section 12 of the Revenue Act of September 8, 1916. The basis

of the excess-profits tax is "the net income of the taxpayer for the taxable year." The definition of "invested capital" contained in Section 207 expressly excludes therefrom "assets," the income from which is not subject to the excess-profits tax.

CONCLUSION

In view of the great importance of this case, it is respectfully submitted that the petition for certiorari should be granted.

JAMES M. BECK,
Solicitor General.

MAY, 1925.

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